Fitch Affirms Louisville & Jefferson Co. Metro Sewer District, KY Revs at 'AA-'; Outlook Stable

Fitch Ratings-Austin-03 October 2017: Fitch Ratings has affirmed the 'AA-' rating on the following Louisville and Jefferson County Metropolitan Sewer District, Kentucky's (the district) debt as follows:

--$1.1 billion sewer and drainage revenue bonds series 2009C (Build America Bonds), 2010A (Build America Bonds), 2011A, 2013A, 2013B and 2013C.

The district's debt outstanding includes an additional $938 million in bonds outstanding not rated by Fitch.
The Rating Outlook is Stable.

SECURITY

The bonds are payable from all revenues from the sewer and stormwater drainage systems, including assessments charged against new connections.

KEY RATING DRIVERS

SIZABLE CAPITAL NEEDS: The district recently finalized a 20-year, $4.3 billion critical repair and reinvestment plan that will address public health and safety risks of the system and incorporates its consent decree (CD). The plan will be primarily debt financed, which should keep the district's debt burden elevated for the rating category.

RATE INCREASES SUPPORT FORECAST: Anticipated annual rate increases of 6.9% are expected to offset increasing debt service and moderate leverage. The district's financial forecast points to stable all-in debt service coverage (DSC) remaining at or near 1.6x and sound liquidity. Debt to funds available for debt service (FADS) is expected to remain relatively stable.

STRONG RATE ADJUSTMENT HISTORY: The governing body has demonstrated a strong commitment to raising rates as necessary, which supports the district's ability to implement continued annual rate increases, as projected. The district's rate structure also benefits from a substantial fixed charge component, which reduce revenue variability.

STRONG SERVICE AREA: The large and diverse service area is the economic engine for the state. Continued steady gains in employment bolster the district's customer base.

RATING SENSITIVITIES

MAINTENANCE OF STABLE FINANCIAL PERFORMANCE: Fitch's Stable Outlook reflects the expectation that Louisville & Jefferson County Metropolitan Sewer District will maintain financial metrics consistent with or better than management's current forecast. However, meaningfully higher debt issuance without offsetting rate adjustments could pressure financial metrics and the rating as the district proceeds through its Critical Repair and Reinvestment Plan.

CREDIT PROFILE

The district provides wastewater collection, treatment, and disposal service as well as stormwater drainage service to around 760,000 people within the boundaries of the Louisville/Jefferson County Metro Government (Metro) and certain outlying areas. Like many large urban wastewater utilities, the district's wastewater system has encountered periodic sanitary sewer overflows (SSOs) and combined sewer overflows (CSOs) during wet weather events, which led to regulatory action against the district. The regulatory actions culminated with the district entering into an amended consent decree (CD) in 2009 with the U.S. Environmental Protection Agency. The CD superseded a prior consent decree and outlines various actions for the district to accomplish in order to achieve compliance with its discharge permits.

SIZABLE CAPITAL NEEDS DRIVEN BY REGULATORY CONSENT DECREE

The CD provides the framework for district actions over a 20-year period (ending in 2024) and is estimated to require total capital spending of around $900 million. Approximately 45% of the estimated costs have been spent to date. Upon completion of the CD milestones, the district expects to capture and treat 96% of all CSOs and eliminate all previously identified SSOs. The system's 2018 - 2022 capital improvement plan (CIP) totals over $829 million, with 51% devoted to CD related projects.

In December 2016, the system finalized a 20 year master plan, which is estimated at $4.3 billion and will address public health and safety risks of the system. The district's capital outlays will be primarily be debt funded. In August 2017, the district issued $35 million in refunding bonds and an additional $175 million in revenue bonds.

The system's debt metrics are weak when compared to Fitch's 'AA' rating category medians and the elevated debt is a concern. The district's current debt per capita of $2,679 is higher than Fitch's 'AA' sector median of $514 and all in annual debt service (ADS) takes up a 37% of the district's fiscal 2016 gross revenues. However, the system has continued to adopt rate adjustments with debt to funds available for debt service (FADs) registering between 11x and 12x for the last five years.

WILLINGNESS TO RAISE RATES A SIGNIFICANT CREDIT STRENGTH

The district's board has raised both wastewater and drainage charges almost continuously since 1991 in an effort to ensure necessary resources for capital spending. In addition, to fund required regulatory capital items, the board (with the approval of the Metro council) implemented a special surcharge in fiscal 2008, effectively boosting charges by 33%. Since that time the board has adopted additional annual increases of 5% to 6% annually since 2009. Additional rate increases of at least 6.9% annually on both the sewer and drainage charge are anticipated through fiscal 2022. While combined wastewater and drainage charges are slightly elevated at 1.2% of median household income (MHI), combined utility charges (including water) fall below Fitch's affordability benchmark of 2% of MHI. The system may seek larger rate increases from the Board in future years and additional revenue would be used to accelerate capital investment in the system.

SOUND FINANCIAL PERFORMANCE/STABLE DSC FORECAST

Continued rate adjustments have produced adequate financial metrics, despite debt costs that have continued to grow. Free cash to depreciation was sound at 115% and generally align with the 'AA' category median of 108%. In fiscal 2016, senior lien DSC was 1.7x and all-in DSC was 1.5x. The district's latest forecast for fiscals 2018 - 2022 points to senior lien DSC of 1.8x to 1.9x and all-in DSC hovering between 1.6x to 1.7x. In recent years, the district's actual performance has been favorable relative to previous forecasts.

DIVERSE SERVICE TERRITORY

Metro (IDR rated 'AAA' by Fitch; Stable Outlook) serves as the major economic engine of the state. The area's job base has diversified over the last decade from primarily manufacturing to include a strong service component. The region saw positive employment gains from 2009 through 2013, including significant additions at the reopened and retooled Ford Motor Company assembly plant (IDR 'BBB'/Stable Outlook). Employment is slightly concentrated with the top ten employers' accounting for 17% of total employment in the MSA. The July 2017 unemployment rate was 5.6% largely on par with the state's 5.9% but higher than the nation's 4.6%. Wealth levels are above the state average at 105% of the state and 85% of the national MHI.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

Applicable Criteria
Rating Criteria for Public Sector Revenue-Supported Debt (pub. 05 Jun 2017) (https://www.fitchratings.com/site/re/898969)
U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 30 Nov 2016) (https://www.fitchratings.com/site/re/890402)

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